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PACIFIC  **TELESIS**
Group-Washington

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MAR 30 1992

Federal Communications Commission
Office of the Secretary

March 30, 1992

Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Ms Searcy:

Re: *CC Docket No. 92-13 - Tariff Filing Requirements for Interstate Common Carriers*

On behalf of Pacific Telesis Group, please find enclosed an original and six copies of its "*Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,



Enclosures

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

MAR 30 1992

Federal Communications Commission
Office of the Secretary

In the Matter of)
)
Tariff Filing Requirements for) CC Docket No. 92-13
Interstate Common Carriers)
_____)

COMMENTS OF PACIFIC TELESIS GROUP

Pacific Telesis Group ("Pacific") files these comments in response to the Commission's Notice of Proposed Rulemaking. This is an important proceeding. It will define the rules by which telecommunications providers participate in increasingly competitive markets, and it will help set the course for the development of telecommunications services for the Nation for the next decade and beyond.

1. INTRODUCTION.

The question here is what regulatory policy for competitive markets is consistent with the Commission's responsibility "to make available ... to all the people of the United States a rapid, efficient, nationwide and worldwide wire and radio communication service with adequate facilities at reasonable prices *****"¹ The choice for the Commission is to

¹ 47 U.S.C. §151.

either reaffirm its present asymmetrical application of forbearance, which has created artificial competition and marketplace distortions,² or retarget its policies in response to new technologies and marketplace realities. If the Commission believes that competition promotes its goals, then the Commission must accept the fact that artificial competition does not.

Forbearance promotes the Commission's goal and encourages competition but only if it is equally applied to all market participants. The present forbearance policy is only applied to non-dominant providers.

The current application of the forbearance doctrine therefore creates artificial competition. It protects "competitors" but not competition. By requiring some but not all participants to file tariffs with cost support, the current policy restricts the ability of so-called dominant carriers to respond to competitive offerings of others. In addition geographically averaged prices establish price umbrellas under which the non-regulated providers can set their prices even though the true economic prices of all providers may be lower. The Commission has a great opportunity here. Armed with its experience in the interexchange market it can remedy the present distortions created by the asymmetrical application of the

² The present detrimental effects of unevenly applied forbearance are set out in "Should The Distinction Between Dominant And Nondominant Firms Be Removed? The Case For Removal" by John Haring of National Economic Research Associates, Inc. and Dennis Weisman of the University of Florida/Southwestern Bell Corporation, hereinafter "The Case For Removal." We have attached a copy of the paper to our Comments.

forbearance rules and set a new policy which advances its goals under Section 151 by encouraging full competition. Our recommendation is the Commission should extend the forbearance doctrine to all market participants in competitive markets, such as interstate digital special access services.

I. THE POLICIES ADOPTED IN THIS PROCEEDING SHOULD APPLY TO ALL TELECOMMUNICATIONS SERVICES AND NOT JUST INTEREXCHANGE SERVICES.

The Commission captions this proceeding as dealing with the application of the forbearance rules to the interexchange market.³ It says it will consider alternatives to the forbearance policy and asks how any alternative should be implemented. We recommend the Commission adopt a new policy and set it out in Section III hereof. The Commission should expressly state that the new policy will apply to all telecommunications services, rather than only those listed in the Competitive Carrier proceeding.⁴

Since the Commission released its NPRM in the Competitive Carrier proceeding in 1979, the telecommunications

³ "AT&T calls into question the Commission's longstanding forbearance rule, under which the Commission forbears from requiring nondominant interexchange carriers (IXCs) from filing interstate tariffs." NPRM, para. 1.

⁴ In the Competitive Carrier proceeding the Commission applied its forbearance rules to nondominant IXCs, miscellaneous common carriers, domestic satellite carriers, (domsats), domsat resellers, domestic operations of Western Union, international record carriers, other record carriers, and IXCs affiliated with exchange telephone companies, NPRM, para. 3, n. 4. Paging is also subject to forbearance. FCC Policy Regarding Filing of Tariffs for Mobile Service, 53 F.C.C. 2d 579 (1975).

industry has undergone nothing short of a wholesale restructuring. AT&T divested its operating local exchange companies; the Commission established the access charge mechanism in CC Docket 78-72 in 1983; equal access was achieved; the interexchange market has become highly competitive; cellular radio services, nonexistent in 1979, have mushroomed; and, the development of fiber-optic based services has spawned local access and local exchange services competition. Even when the Commission issued its Sixth Report and Order in Competitive Carrier in 1985, access services and tariffs were still in their infancy.

Competition has spread from the interexchange to the access services market. The Commission recognized this fact in 1991 when it issued an NPRM in the Matter of Expanded Interconnection with Local Telephone Company Facilities, CC Docket 91-141. There the Commission stated that "Competitive Access Providers (CAPs) now offer access services to large business customers in the central business districts of many major cities."⁵ It also recognized that end users also use microwave and other radio-based facilities in lieu of LEC access services.⁶ Additionally, IXC facilities which directly connect

⁵ NPRM CC Docket 91-141, para. 2. The CAPs, such as Metropolitan Fiber Systems and Teleport Communications Group do not file interstate tariffs with the Commission. They apparently believe that they qualify for forbearance as nondominant IXCs. Pacific notes, however, that the Commission has not passed upon CAPs' status under the Competitive Carriers decisions.

⁶ Id., n. 3.

to end-user locations provide the capabilities of LEC access networks, and IXC POP proliferation and "closet" POPs enable IXCs to avoid the distance sensitive component of LEC access services.

The Commission has already taken note of these major changes in the telecommunications industry. It needs to recognize those changes in this proceeding. The policies adopted here should not be limited to the services set out in the Competitive Carrier decisions which do not recognize developments since those decisions. Interstate access competition was non-existent when those decisions were made. Any new policy must address the changes in the industry and should apply to all telecommunications services.

II. COMPETITION SHOULD BE ANALYZED BY MARKET SEGMENT AND NOT BY CLASSIFICATION OF THE PROVIDER.

The Competitive Carrier decisions applied the forbearance rules to certain classes of carriers - nondominant IXCs and other telecommunications providers. Nondominant status depended upon the competitive status of the carrier and not the market. While that classification may have been valid thirteen or even seven years ago, it no longer is.

Today, carriers provide services to selective markets. In its petition for rulemaking, MFS proclaimed its "networks ... currently serve the highly specialized communications needs of interexchange carriers and business and governmental users."⁷

⁷ MFS Petition for Rulemaking, pp. 5-6.

When the Commission opened its rulemaking proceeding In the Matter of Expanded Interconnection With Local Telephone Company Facilities, CC Docket No. 91-141, it was a recognition that niche markets which were competitive had developed. That proceeding focuses on the interstate special access services market. The Commission stated:

For many years, local exchange carriers (LECs) faced little or no competition in providing the local access facilities and services used in the provision of interstate communications. Recent changes, however, have facilitated the development of competition in the provision of these facilities and services. ... [W]e have restricted our proposal to the provision of special access service,⁸ which is used largely by business customers.

The Commission also recognized the existence of competitive markets In the Matter of Competition in the Interstate Interexchange Marketplace, CC Docket 90-132. The Commission observed that there is competition in the interstate market generally and concluded "competition among IXCs in business services may be especially intense."⁹ This was an acknowledgement that within the provision of interexchange services there were particular markets, some of which are more competitive than others. In its Report and Order in CC Docket 90-132, the Commission confirmed this view by streamlining its regulation of most of AT&T's Price CAP's business services and most of its services outside of price cap regulation.¹⁰

⁸ NPRM CC Docket 91-141, paras. 2, and 4.

⁹ NPRM CC Docket 90-132, para. 59.

¹⁰ Report and Order, CC Docket 90-132, para. 22.

What the Commission did in CC Docket 90-132 was to amend its forbearance doctrine. Instead of treating AT&T as entirely dominant, it examined the various markets in which AT&T provides services and determined which were or were not competitive. The Commission has thus already moved away from the provider classification scheme used in the Competitive Carrier Proceeding to a market analysis approach for determining the appropriate level of regulation.

This approach should be applied to all telecommunications services and markets, whether they are wire or radio based. The Commission has concluded that there is competition in the interstate access market, and it should apply the policy we recommend in the next section to that market.

III. REAL COMPETITION REQUIRES COMPETITORS BE TREATED SIMILARLY.

If a market is competitive - like interstate digital special access services - the Commission should treat all market participants similarly for that market segment. The asymmetrical regulation which exists today does not promote true competition because it handicaps certain providers.

First, competitors use the tariffing process imposed on regulated providers like the LECs to delay LEC offerings. They protest LEC filings to preclude, if not frustrate, a new service offering or price in response to the competitors' offerings. Second, tariff requirements based on geographically averaged costs establish price umbrellas under which those competitors can price their services free from competitive price responses by the

LECs. Those competitors recognize this and protest LEC price reductions.

These incentives and consequences created by asymmetrical treatment of competitors were analyzed in "The Case For Removal." The authors pointed out that an incumbent firm's freedom to compete is significantly constrained and "the regulatory gauntlet ... affords abundant opportunities for delay and exploitation of complexity."¹¹ Pacific Bell's experience with its Special Access tariffs demonstrates these results. MFS uses the regulatory process to try to decrease the rates for services it purchases and increase the rates for services which are competitive.¹²

The paper argues that the Commission basically has two alternatives: first, it can allow all providers the same opportunities to compete and rely on competition to prevent undue discrimination; or second, it can limit the freedom of all

¹¹ "The Case For Removal," p. 5.

¹² In their comments in CC Docket 91-141, MFS stated "In order to make virtual collocation as close an approximation of physical collocation as possible, the Commission should require that the same rate elements apply regardless of which form of interconnection is provided." p. 76. But the costs of physical and virtual collocation are different. In this situation, MFS wants ratepayers to subsidize the service MFS purchases. At the same time, MFS files petitions to reject Pacific Bell's tariff filings which MFS views as competitive. The most recent example is its petition to reject Pacific Bell's Transmittal No. 1563 to offer Alternate Serving Wire Center (ASWC) filed December 31, 1991. In its petition MFS alleges "Pacific's filing appears to exclude significant cost elements...."

providers to compete and rely on regulation.¹³ The authors believe the first course of action is highly preferable. We do too.

Where competitive markets exist - such as interstate digital special access services - the Commission should reduce or eliminate regulation. Specifically, the price cap bands on LEC digital special access services should be removed, and LECs should be able to offer customized services. Only when all competitors are able to provide services and set prices in response to the market will the benefits of competition reach all the customers in a market and will the Commission's goals and responsibilities be fulfilled.

IV. CONCLUSION.

Pacific Telesis Group urges the Commission to expand the scope of this proceeding and apply the policies developed here to all telecommunications services. This is appropriate because of the significant changes in the telecommunications industry since the Commission first established its forbearance rules in the early to mid 1980s.

Many of these changes have been recognized by the Commission in its recent NPRMs concerning interstate interexchange competition, CC Docket 90-132 and expanded interconnection with LEC facilities, CC Docket 91-141. These proceedings acknowledge the development of competition in


¹³ Id. at p. 14.

particular markets - like interstate digital special access - and that competition should be analyzed by markets and not by provider status.

Our proposal is to reduce and eliminate regulation in competitive markets. Only if the Commission addresses both sides of the equation - market entry and incumbent restrictions - can true competition be promoted. If the Commission chooses to only address market entry issues and to ignore the restrictions imposed by current regulation on incumbents, it will only promote artificial competition which protects competitors but does not provide true competitive benefits to customers.

Respectfully submitted,

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**"SHOULD THE DISTINCTION BETWEEN DOMINANT
AND NON-DOMINANT FIRMS BE REMOVED?"**

The Case for Removal

John Haring
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and

Dennis Weisman
University of Florida/Southwestern Bell Corporation

**Prepared for the MSU Institute of Public Utilities
Twenty-second Annual Williamsburg Conference**

**"Adapting Regulation to Public Policy Changes and
Emerging Industry Structures"**

**December 10-12, 1990
Williamsburg, Virginia**

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I. INTRODUCTION

The distinction between dominant and non-dominant firms is a theoretically valid distinction. In theory, dominant firms possess the unilateral power to raise prices and restrict market output, whereas non-dominant firms can raise prices and restrict market output successfully only by acting in effective consort with their rivals. To argue that this distinction should be "removed" would be equivalent to arguing that the distinction between the theories of supply and demand or between Newtonian and nuclear physics should be removed.

We thus interpret the question of whether the dominant/non-dominant distinction should be removed to refer to the legitimacy of its application in any particular industry setting and to the nature of the differences in regulatory burdens that should properly flow from drawing the distinction where applicable, in particular, to the efficacy of asymmetrical regulation of competing carriers.

Haring and Levitz (1989) have argued that the long-distance market is now more accurately and usefully modelled utilizing the tools of oligopoly theory rather than the dominant-firm model of industrial organization economics. On this view, strategic interaction among long-distance competitors is the real name of the game, not discretionary, unilateral behavior by one supplier. Not everyone agrees with this view, but at least one benefit of

the discussion that the Haring-Levitz paper has prompted is that it has focused attention on the right question for determining dominance, in particular, whether supply is sufficiently elastic to prevent AT&T or the exchange companies from unilaterally raising market prices in particular markets.

Haring and Kwoka have previously debated this question¹ and the docket in the FCC's current long-distance rulemaking proceeding contains much evidence on the issue.² Rather than repeat that debate or simply summarize the various submissions in the FCC's docket, the focus of this paper is on the second set of issues to which we alluded above.

The only proscription of dominant-firm behavior that can be defended on economic grounds as unambiguously capable of improving economic welfare is prevention of monopolistic price increases.³ This, by the way, was the policy prescription Haring and Levitz claimed would be potentially justifiable if the dominant-firm model were a valid characterization of actual circumstances.⁴ For purposes of this discussion, let us assume that, regardless of whether the dominant-firm model or an oligopoly model more accurately captures relevant reality, monopolistic price increases are effectively proscribed by (actual or potential) regulation. The policy debates about appropriate regulation of leading incumbent carriers do not, in any event, focus on the freedom to raise prices; they focus instead on the freedom to cut prices and compete.

This paper thus analyzes the economic consequences of three alternative rules or tests for "just and reasonable" rate-setting by leading incumbent firms confronted with actual or potential competition. Its application to the telecommunications industry, where interexchange competition is now a familiar reality and where exchange competition is

¹ See "Economic Perspectives," presented at CompTel Conference, "The AT&T Dominance Debate," Washington, D.C. (September 14, 1990).

² See In the Matter of Competition in the Interstate Interexchange Marketplace, FCC CC Docket No. 90-132.

³ See Richard Schmalensee (1987).

⁴ See op. cit., p. 5.

increasingly manifest, is clear and what principally motivates our discussion. Similar issues, of course, arise in a variety of other industry contexts.⁵

The rules of the competitive game matter a lot. They affect the magnitude and nature of the benefits consumers can expect to derive from the operation of a competitive process as well as the efficiency of the dynamic transition from one market structure to another. Our analysis, for example, suggests that the rules relied upon to govern competition in the long-distance business have probably failed to maximize consumer welfare and have possibly been wasteful and counterproductive in promoting effective competition in both this and other markets.

Indeed, the rules of the long-distance game at this late date -- six years after divestiture and more than a quarter of a century since the competitive experiment was begun -- remain unsettled and have not yet been completely specified. This, in part, reflects the natural desire of government decisionmakers to have it all ways as manifested in their frequent reluctance to live with the economic consequences of competition and to relinquish control (and attendant political power) over market outcomes. It also reflects a sometimes related desire to promote the interests of industry infants to insure their survival. In a very real sense, the so-called "competitive revolution" in telecommunications has often consisted less in the substitution of market for governmental processes of resource allocation than it has the simple addition of a new factional interest (viz., the entrants) to be mollified via the operation of conventional regulatory and political processes.

Since the rules that have governed the long-distance experiment have involved significant handicapping of the competitive process, it is by no means clear what lessons about the long-term viability and efficacy of that process can be prudently drawn. Now competition at the local exchange is at hand and it poses virtually the same issues and potential conceptual difficulties. Our analysis is thus at least timely.

⁵ Electric power and natural gas distribution are notable examples.

II. COMPETITOR NECESSITY

The first regime we consider is the one that has actually governed and, to a significant extent, continues to govern the unfolding saga of competition in telecommunications. We refer to this regime as one of "competitor necessity" since the operative principle is one which focuses on the welfare of competitors, rather competition per se, and arguably one which may be necessary for the viability of at least some competitors. Instead of competition supplying a means to an end, on this view competition -- by which is meant the existence of competitors -- is an end in itself and the success of the competitive experiment is measured by the success of particular competitors rather than the efficiency with which resources are allocated. Normally, attempts by private enterprises to cloak themselves in the public interest are viewed with skepticism, but, in telecommunications, the view is that what's good for particular businesses is good for America is rarely challenged. There is, of course, no necessary connection between the welfare of consumers or the effectiveness of competition and the welfare of particular telecommunications competitors. The survival of any given enterprise may suggest that competition is working or it may suggest that competition is failing as it would if, for example, an enterprise were competitively unfit.

Under a "competitor necessity" test, the incumbent firm's freedom to compete is significantly constrained. These constraints usually take two forms: (1) limitations on the incumbent's ability to reprice its services and to offer new services; and (2) asymmetrical regulation which subjects the incumbent's, but not the entrants' tariffs to monitoring, review and a complaint process and which may also effectively subsidize entry. Under the FCC's asymmetrical regime, only leading incumbents are typically compelled to file tariffs. In addition to these regulatory controls, incumbents are usually also required to serve as the carrier of last resort, supplying service when or where others will not.

To evaluate the consequences of this type of regulation, we consider the effects in three stylized markets: markets for "transport," "access" and "innovation." Let us assume that, at the outset, the regulated price of transport exceeds the variable costs of providing

transport for some customers (see Table 1), perhaps due to some form of rate averaging or failure to react to changes in technology which should be reflected in the structure of rates.⁶ This excess contributes to coverage of overhead and the common costs of providing transport and access service and may also involve an explicit subsidy to provision of access (*viz.*, an access price below relevant cost).

Table 1
Entrant's Choice of Investment Under Asymmetrical Regulation

	Transport		Access		Innovation	
	Price	Cost	Price	Cost	Price	Cost
Incumbent	10	4	25	30	P R E C L U D E D ?	
Entrant	9	5	?	?	8	5

Under a "competitor necessity" regime, this set of prices is essentially fixed by regulation. It may be subject to small changes, but only as a result of tariff filings and success in running the regulatory gauntlet which affords abundant opportunities for delay and exploitation of complexity. While commentators frequently stress the role of technology in explaining the competitive revolution in telecommunications, technology is, in fact, merely a necessary condition for competition. It provides a supply capability, but not necessarily a profitable supply opportunity. The latter is, in our example, provided by the price/cost margin assumed (fixed) in the transport market.

A high margin in the transport market provides an incentive for competitive entry, but it simultaneously reduces incentives for entry into the access market. To succeed in the transport market, an entrant must beat a relatively easy mark -- the incumbent's high fixed price, which is, by assumption, significantly in excess of variable costs. To succeed in

⁶ For example, the historical evolution of switching technology from step-by-step cross-bar to analog electronic and digital electronic implies a diminishing ratio of variable to fixed costs and the desirability of a rate structure with higher fixed and lower variable components.

the access market, on the other hand, an entrant must beat a relatively difficult mark -- the incumbent's low fixed price, which may, by assumption, lie below actual costs of production. This implies that a high-cost competitor in the transport market may succeed, while a low-cost competitor in the access market might fail.⁷ It suggests that one adverse consequence of this type of regulation is potentially to bias investment decisions (in this case as between the transport and access markets), a point to which we return presently.

The effects of entry are to reduce the price paid for transport with the inevitable consequence that, regardless of the rules governing incumbent response, (either) access customers pay higher prices (or stockholders suffer equity losses).⁸ That is because contribution to common-cost recovery and to any subsidy is reduced. It is sometimes suggested that affording incumbents pricing flexibility to respond to competitive entry will hurt so-called "captive" customers, who will be compelled to fund any discounts. Our point is that (either) these customers (or the incumbent firm's stockholders) will pay for any discounts regardless of who offers them. In fact, rate increases (or equity losses) may be even greater if the incumbent is not allowed to respond. As long as the incumbent's discounted rates cover variable costs, any excess can contribute to overall cost recovery and permit access to be priced closer to the socially desired level.

Frequently, incumbents are required to price to favor particular customer classes, including their own competitors. For example, under the FCC's unequal-access pricing regime, AT&T's competitors were charged noncompensatory, discounted prices which failed to cover the incremental costs of providing technically inferior access to them including a compensatory contribution to fixed-cost recovery. These shortfalls were made up in higher charges for superior access by AT&T. Similarly, exchange telephone companies have historically often relied upon usage-sensitive pricing schemes while the majority of their costs

⁷ Given the historical subsidy to local service, the lack of entry there and the occurrence of entry into long-distance service is thus easily explained in these terms.

⁸ If access rates are effectively capped or raised only slowly and with great difficulty, stockholders are left holding the bag. No firm can sustain equity losses perpetually.

are incurred to provide for the option of use rather than actual usage. Large corporate customers with private networks may thus pay charges which fail to cover the costs their use of the public network, though occasional, nevertheless causes to be incurred.⁹

In these situations, failure to allow the leading incumbents to respond to competition by altering their prices may make things even worse for other access customers (or stockholders). That is because in each case the overhead burden itself rises as business is lost. We have seen how loss of contribution can put upward pressure on access prices (or downward pressure on stock prices) with a fixed overhead burden. That pressure will be increased when what causes loss of contribution also causes the fixed burden itself to grow given noncompensatory regulatory pricing schemes. To the extent access rates are capped, losses to competition flow directly to shareholder equity, an unsustainable result.

The implications of a "competitor necessity" regime for efficient resource allocation are ambiguous. In our example, entry into transport lowers the price of that service for some customers producing a welfare improvement, but whether aggregate economic welfare will be expanded depends on the level of the entrant's costs. If the incumbent is not allowed to respond to entry or is allowed only those responses which are ineffective or self-defeating, new firms may be able to enter and compete effectively even though their costs are greater than those of the incumbent. Thus, economic welfare may be reduced if the gains from a lower price are more than offset by the losses from less efficient production.¹⁰ If regulatory pricing constraints encourage use of inefficient technology, the economy's overall productive capabilities will be reduced preventing maximization of society's aggregate economic welfare.

⁹ See Dennis Weisman (1988 and 1989).

¹⁰ On the nature of the economic tradeoffs between allocative and technical efficiency, see Oliver Williamson (1968). John Wenders (1988) has argued forcefully and persuasively that there really is no such thing as uneconomic bypass and that consumers should always be permitted to contract freely to improve their position even if this entails technical inefficiency and resource waste. We agree; our position is not that bypass should be prevented via fiat but that it should not be encouraged via artificial restraints on any competitor's freedom to price efficiently. Pricing freedom will minimize technical inefficiency and maximize gains in consumer welfare.

A price umbrella may not only encourage excessive investment and lead to higher costs than necessary;¹¹ it may also discourage investment in economically desirable alternatives such as the provision of new innovative services. Note that, in our example, a rational competitor would choose to enter the transport market rather than the market for innovation because the payoff there is greater given "competitor necessity" regulation. This result could easily occur even though transport entry may involve higher costs and fail to improve economic welfare overall. Under "competitor necessity" regulation, investment signals are distorted and this may lead to inefficient, and perhaps irreversible, investments.

"Competitor necessity" regulation attempts to promote competition by promoting a competitive industry structure (as embodied in, say, an aesthetic distribution of market shares) rather than effectively competitive performance. This type of regulation is fraught with both difficulties and risks. The optimal industry structure is generally unknown and can be discovered only through the operation of a competitive process.¹² The government's ability to create an optimal industry structure is questionable even if one assumes the government knows what the optimal structure is, which, in fact, it does not.¹³ If the government succeeds in creating an artificial industry structure, how can it then sustain that structure without continuing intervention? If entry and the viability of additional suppliers are driven by inefficient regulatory pricing, must the government maintain or create even greater pricing distortions to sustain competitors? What can the government legitimately

¹¹ Consider, in this regard, the huge overhang of excess capacity asymmetrical regulation has produced in the long-distance business. Robert Crandall (1988, p. 31) has analogized the frantic investment in fiber-optic networks to the rush to build railroad lines in the last century. He remarks that "Given the history of transportation regulation, we know that continued rate regulation and liberalized entry are a potentially lethal combination. Regulators inevitably find themselves hostage to inefficient competitors. It now appears that investment in interstate telephone transmission has been excessive."

¹² See John Haring (1984).

¹³ Government attempts to modify industry structure in other industries have often failed. See John Meyer et al. (1980). The economic revolution currently underway in Eastern Europe certainly represents a thorough rejection of the efficacy of industrial planning by government.

conclude about the genuine viability of a self-policing industry structure on the basis of experience with an artificial industry structure?

Government promotion of competitors also poses serious problems of moral hazard (as the savings and loan debacle amply demonstrates). Protection from competition reduces pressure to operate prudently and efficiently. How does the government protect itself from becoming a hostage to the incompetence or opportunistic behavior of its wards? If the government is going to protect competitors from failure, how does it insure against sloth, dishonesty and recklessness? If competitors are shielded from the consequences of their failures, what incentives do they possess to avoid error and improve their performance?

Against these difficulties and risks must be weighed any competitive benefits. But the existence of benefits under "competitor necessity" regulation is problematical. Entry and investment decisions are skewed. Entry into markets for new innovative services may be discouraged and the entry which is encouraged may not actually improve economic welfare if the entrant's costs are higher than the incumbent's. If the incumbent firm is not permitted to respond and structure its prices efficiently, the effect may simply be to substitute high-cost competition for low-cost monopoly.¹⁴ A self-policing industry structure may allow deregulation and, thus, free up scarce regulatory resources to perform other tasks. But how can the authorities conclude that an industry is sufficiently competitive to police itself when all it has to go on is experience with an artificial industry structure, the result of regulatory handicapping? That is not to argue against competition and competitive entry; it is to argue against "competitor necessity" regulation.

Competition is a discovery process. It cannot discover the best mix of products and services or the identity of the most efficient suppliers if it is not permitted to operate effectively. "Competitor necessity" takes the status quo ante and tries to turn it into an immutable given. By so doing, it guarantees the unsustainability of the status quo ante, but offers no guarantee that resources will actually be allocated more efficiently. Indeed, there

¹⁴ See Schmalensee, op. cit.

are a variety of reasons to expect that they will tend not to be. Thus, this particular leap from the frying pan may perhaps land us in a comfortable bed of roses or, as seems as or more likely, the fire.

141. COMPETITIVE NECESSITY

An alternative to a "competitor necessity" regime is one of "competitive necessity." The doctrine of "competitive necessity" is the rule governing permissible responses to competition under antitrust law. It basically holds that what might otherwise be deemed an unduly discriminatory price may nevertheless be justifiable if the price is narrowly tailored to "meet" (but not beat) the actual offering of a competitor in the marketplace.

If "competitive necessity" were the prevailing standard, the incumbent in our example would be permitted to match the price set by the entrant in the transport market with several beneficial economic consequences. If the incumbent is the low-cost provider, allowing the incumbent to meet the entrant's price may permit the incumbent to limit its loss of business and, by so doing, prevent the inefficient substitution of higher for lower-cost means of production.

Purchasers of transport service, who are the target of discounts, are as well off as under a competitor necessity regime. They get the same deal. Access purchasers (and the incumbent firm's stockholders) are better off compared to the situation under "competitor necessity" rules because, while the contribution to common and access-cost coverage is reduced, it is not reduced by as much when the incumbent is afforded some flexibility to respond. When allowed to respond, the incumbent can keep some of the traffic that otherwise might have been lost. Since the market price continues to exceed the incumbent's variable costs, there is an excess which can contribute to fixed-cost burdens.

Investment incentives may also be beneficially altered under a "competitive necessity" regime. Entry into transport will appear less attractive compared to alternative investments. Scarce investment resources may thus be allocated to production of alternative goods and services which generate greater actual improvements in economic welfare. In our

example, an investment in innovation may be more attractive if the prospective payoff to investments in transport is reduced.

While we believe a "competitive necessity" regime is preferable to a "competitor necessity" regime, it is not without its own difficulties and demerits. Under "competitive necessity," the incumbent is permitted to meet, but not beat the entrant's price. Thus "competitive necessity" would not permit an incumbent to price so as to exclude less efficient competitors. It is well within the realm of possibility for such pricing to be capable of actually maximizing contribution to burden coverage. A lower price sacrifices some contribution, but it may simultaneously increase contribution, mutatis mutandi, if business that otherwise might be lost is retained. Lower contribution per customer may be more than offset by increases in the number of customers contributing. Moreover, as long as pricing to exclude less efficient competitors is impermissible, investment incentives continue to be skewed.

As we have noted, under a "competitive necessity" test, incumbents are permitted to respond to competition by meeting, but not beating a rival's offering. This standard disadvantages incumbents in at least two ways. First, incumbents are permitted to respond, but not to initiate. In the contest for consumers' favor, a "responder" is likely to play at a disadvantage compared to an "initiator," ceteris paribus. The ability to respond by matching, but not exceeding a rival's offering may thus fail to constitute a competitively effective response. To the extent that it does not, the adverse consequences we have enumerated remain a possibility, albeit to a somewhat attenuated degree assuming the incumbent has at least some success in retaining customers.

Second, to avail itself of the freedom to respond under a "competitive necessity" test, an incumbent must be able to fashion a competitive response that merely meets a rival's offering. In practice that is liable to be difficult to do and the terms of any proposed response would undoubtedly supply the grist for administrative complaint processes and attendant delays.

Perhaps the most serious disability of "managed" competition is that it provides powerful incentives for "rent-creation" and "rent-seeking" behavior by market participants through exploitation of the government's administrative processes. Resources that might otherwise be employed to expand aggregate economic welfare in the marketplace are instead deployed in a fundamentally unproductive attempt to gain artificial advantage through governmental favoritism. Regulatory challenges that hinder a rival's ability to compete may be privately beneficial to some competitors, but they limit the benefits consumers reap from the free-play of competitive forces in the marketplace. The tougher the mark any individual competitor has to beat, the greater the potential gains to consumers.

The problems of fashioning an acceptable, yet effective, response are likely to be particularly thorny in cases where competing services are not in direct competition with one another, but exist in an economically complementary relation. For example, many businesses operate their own private networks because they can exercise a high degree of control and save money. One reason they can save money is that, as noted previously, use of the public switched-network is frequently priced on a usage-sensitive basis while costs are typically incurred to provide for the option of use. A business may thus be able to route overflow traffic through the public-switched network and pay rates which fail to cover the costs this occasional use causes to be incurred. A usage-sensitive pricing scheme may thus actually subsidize competition via private networking.¹⁵ Could an exchange company justify an economically rational two-part tariff for transporting overflow traffic in this situation as (part of) a legitimate "competitive response" to private network alternatives? Perhaps it could do so, but, in our view, only with great difficulty and little chance of immediate success.¹⁶

The doctrine of "competitive necessity" thus supplies an imperfect rule, which would limit competition and continue to provide a protected haven for inefficient entry with

¹⁵ See Weisman, op. cit.

¹⁶ For a specific example of a notable failure, see Weisman, op. cit.